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CONCERNING

"REVIEWING U.S. CAPITAL MARKET STRUCTURE:

THE NEW YORK STOCK EXCHANGE AND RELATED ISSUES"

BEFORE

COMMITTEE ON FINANCIAL SERVICES –

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND

GOVERNMENT SPONSORED ENTERPRISES

UNITED STATES HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

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Chairman Oxley, Chairman Baker, Vice-Chairman Ose, Ranking Member Kanjorski, and other distinguished members of the Subcommittee, I am Jerry Putnam, Chairman and Chief Executive Officer of The Archipelago Exchange or "ArcaEx," and am pleased and honored to submit my written statement to you. I commend the Subcommittee for holding this timely hearing on the status of U.S. capital market structure and, in particular, for performing a thorough examination of the regulatory and competitive fitness of the structure of our listed equity marketplace. [1]

Now is a historic time to take up this critical review and encourage, if not spur, balanced and market-oriented reform of our listed equity markets. While Congress has been tackling very weighty issues – everything from war in Iraq to accounting reform to threats of terrorism to national energy policy – our capital markets have persisted despite the shock of 9/11, the bursting of the Nasdaq bubble, and the corrosive exhaust of corporate scandals. Notwithstanding their remarkable resilience, the market structure underlying our listed markets – in contrast to the vibrant and healthy over-the-counter marketplace – evidences all the lethargic and inefficient symptoms of anti-competitive and monopolistic pathology. And, when discussing the guts of our listed markets, that conversation today essentially begins and ends with the NYSE and its 80% market share and the inter-market mechanisms and regulator truncheon that they leverage to protect that market share.

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[1] The "listed marketplace" is defined as those national securities exchanges and self-regulatory organizations that trade NYSE- and AMEX-listed securities, as well as securities listed on their own markets, and include ArcaEx (as a facility of the Pacific Stock Exchange), Boston Stock Exchange, Philadelphia Stock Exchange, Cincinnati Stock Exchange, Chicago Stock Exchange, NASD (Nasdaq 3rd Market) and, of course, the NYSE and AMEX, themselves. These listed markets interface and interact with one and other in accordance with inter-market regulations and rules governed by national market system committees and by the Securities and Exchange Commission (SEC). In contrast, the "over-the-counter (OTC) marketplace" is defined as those national securities exchanges and self-regulatory organizations that trade Nasdaq securities and include many of the entities listed

It was only a few years ago that under the discerning leadership of Chairman Oxley and other Members of this Subcommittee that our capital markets ushered out the anachronistic Spanish “pieces of eight” (*e.g.*, 1/8s, 1/16s) and ushered in the “era of the penny” (or decimalized trading). The result has been the equivalent of a billion dollar “tax cut” for investors. Here, this Subcommittee is in a position to effect another round of stimulative “tax cuts” for investors by tearing down the now ancient walls and draining the medieval moat that protect the well-fortified NYSE and replacing them with a splendid kingdom built on a foundation of competition, market forces, and customer choice.

I. Recipe for Success: A Heaping Tablespoon of Competition

You can hardly pick up a financial newspaper or magazine or cruise your cable channels without reading or hearing the headlines: “Conflicts of Interest Involving Commingled Regulator and Marketplace,” or “Governance Conflicts of Marketplace Board of Directors Consisting of Regulated Entities,” or “Doubts about Execution Quality for Investors Delivered by Inside Players in Monopoly Marketplace.” Of course, I am talking about the New York Stock Exchange in 2003, right? No, I was actually referring to the **Nasdaq marketplace** in 1995. (Well, my statements really apply to both.)

My literary point is that the overarching issues of propriety and potential malfeasance now confronting the NYSE are not historically novel ones. To the contrary, we witnessed the same and similar problems during the Nasdaq price-fixing scandal of the mid-1990s that

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immediately above such as ArcaEx. The “OTC marketplace” is structured under a wholly different set of inter-market regulations, rules, and committees than the “listed market.”

culminated in sanctions being brought by the SEC and the Department of Justice. [2] As you will recall, the Nasdaq scandal involved, principally, conflicts of interest between the NASD regulator and its commingled Nasdaq marketplace; and, investors being substantially disadvantaged by inside players (market makers) for the direct benefit of those same inside players. With this history serving as our guide, the seeds of NYSE reform and “fixing” the listed marketplace reside in the ashes and renovation and later rejuvenation of the OTC marketplace.

Of the several reforms exacted on the OTC marketplace, none was more profound and did more in benefiting investors than the lowering of entry and competitive barriers. This was accomplished through the introduction of market structure changes commonly referred to as the Order Handling Rules. [3] Not surprisingly, lower barriers cultivated an environment – primarily driven by Electronic Communication Networks (ECNs) and Alternative Trading Systems (ATSs) – resulting in the introduction of rapid technological innovation, unprecedented cost efficiencies, and an “investor comes first” ethos. What once was a Byzantine playground for insiders doling out dubious execution quality to investors, the OTC marketplace today – which consists of competitors like ArcaEx, Nasdaq, Instinet, and the Cincinnati Stock Exchange – provides more choice, functionality, speed, efficiency, and, yes, ***better execution quality*** (as recent studies show) than the NYSE.

With the past serving as prologue, and the injection of competition proving to be just the right antidote to cure the OTC marketplace, we would respectfully suggest that the same medicine be administered to cure the ills of the NYSE. That medicine being good old-fashion

[2] *See* Report Pursuant to Section 21(a)of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market, SEC, August 8, 1996.

[3] Securities Exchange Act Release No. 37619A (September 6,1996), 61 FR 48290 (September 12, 1996) (File No. S7-30-95).

"competition." Over the years, the NYSE has installed anti-competitive barriers that have taken several shapes and forms (*e.g.*, NYSE Rules 390, 394 & 500). Today, however, the manifestation of NYSE anti-competitive barriers is the Inter-Market Trading System (ITS) Plan, its "trade through" provision, and the ITS Operating Committee that "administers" the ITS Plan. As the Order Handling Rules ignited reform by introducing competitors and transforming the OTC marketplace into a highly dynamic one, so too will reform of the "trade through" provision of the ITS Plan, which will lower competitive barriers and introduce authentic competitors to the NYSE marketplace. Put succinctly: what the Order Handling Rules did for the OTC marketplace, ITS and "trade through" reform will do for the NYSE marketplace. And, as was the case in the OTC marketplace, the investor will be the ultimate winner.

II. <u>ArcaEx: Rooted in Competition</u>

The seeds of ArcaEx were sown in the immediate aftermath of the Nasdaq scandal. I read the Order Handling Rules in late 1996 and identified an opportunity to design a business based on a simple but, at the time, quite revolutionary principle: "do the right thing" by creating a level playing field for all investors in an industry filled with conflicted insiders and unnecessary intermediaries. I reasoned that any business model that was good for customers (investors) would be a profitable one for Archipelago. Along with MarrGwen and Stuart Townsend – and my mortgage banker, I might add – I founded the Archipelago ECN (the regulatory predecessor to ArcaEx), which was one of the new competitors to enter the OTC marketplace in 1997.

We branded our business model as "best execution" by delivering to our customers: (1) access to full and timely market information; (2) fast electronic and anonymous executions; (3) sophisticated order types and other value-added functionality; and, arguably our biggest contribution to market structure, (4) algorithmic outbound routing to guarantee best price when that price did not reside at Archipelago. The outbound routing innovation was confirmation of one of the congressionally-articulated goals in mandating the development of the National Market System in 1975. [4] Archipelago created an electronically linked marketplace and, thus, a large virtual pool of liquidity, where customers were given electronic access to best prices at other marketplaces. Archipelago conducted business by the credo: no special handshakes, no backroom deals, no free options, and no conflicts; instead, all investors compete using the same tools and possessing the same market data information. That was our competitive differentiation.

In late 2001, after working with the dedicated staff of the SEC for two years, the SEC Commissioners unanimously approved ArcaEx to operate the first totally open electronic stock exchange. ArcaEx became operational to trade listed stocks in 2002 and OTC shares in 2003. Today, ArcaEx is ***the largest electronic stock exchange in the world*** (based on dollar volume) and is the ***second largest exchange in the United States*** (based on trading volume). From literally zero volume as an ECN in 1997, ArcaEx now handles 28% of the trade volume in the OTC marketplace and 4-5% in the listed-marketplace, and is the largest marketplace for Exchange Traded Funds (ETFs), including QQQ, the most actively traded equity product in the world. Archipelago handles about 650 million shares a day with a record day approaching three-quarters of a billion shares.

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4 *See* National Market System (NMS) Amendments of 1975 to the Securities Exchange Act of 1934.

Importantly, ArcaEx's business success is matched by its regulatory and compliance success. In the same spirit of "doing the right thing" for investors by operating an open and un-conflicted trading platform, ArcaEx designed its marketplace to eliminate legal or regulatory conflicts by **not engaging** in the regulation of its own marketplace. Instead, ArcaEx operates as a facility of and is regulated by the independent Pacific Stock Exchange (PCX). The lines between business, which is operated by ArcaEx, and regulation, which is operated by PCX, are bright and distinct. As CEO of ArcaEx, all business employees and no regulatory employees ultimately report to me. On the other hand, all regulatory employees of PCX who oversee ArcaEx report to its CEO, Phil DeFeo. Additionally, PCX has its own Board of Directors that is separate from ArcaEx. The PCX Board is charged with its own fiduciary and regulatory obligations independent of ArcaEx's. In the ArcaEx/PCX model, the conflicts involving a regulator wrapped tightly and integrally around a marketplace do not exist.

III. The Roadmap: Competition Through Reform of ITS

Like other exchanges, ArcaEx was compelled to link to the NYSE via ITS and sign onto the ITS Plan, which includes a general prohibition on "trade through." "Trade through," as defined in the ITS Plan, was designed for a 1970s market structure when all exchanges were slow and manual- and specialist-based ones. In today's electronic world, it limits customer choice and dumbs-down "best execution" to the lowest common denominator of the slowest markets, which often consist of conflicted specialists who use "trade through" to their profitable advantage.

Joining ITS and signing onto "trade through" is a *sine qua non* to operating an exchange, and the NYSE clearly recognizes and uses that against its competitors. How? ArcaEx's experience serves as a representative proxy. In order to join the ITS club, we had to endure a NYSE "hazing process" for months and months before we were "initiated" on NYSE "take it or leave it" terms. The NYSE was in a position to extract unreasonable concessions (blood) from ArcaEx because the ITS Plan is governed by a one-blackball structure where the NYSE can arbitrarily veto the entry of competitors. Further, in order to amend and modernize the ITS Plan (read: reform it), the NYSE can and does use its blackball (or threatens so) to stifle much-needed innovation.

Case in point: the SEC and much of the industry have called for (demanded) ITS reform over the last 18 months. The ITS Operating Committee, which includes exchanges with many divergent interests, was actually able to work in good faith and hammer out a couple of reform proposals that included much compromise. The NYSE (and AMEX) blackballed these reforms, the result being infinite filibuster for reform with no opportunity for cloture. The upshot: by employing its anti-innovation blackball, the NYSE has maintained the status quo and its 80% market share by compelling fast electronic markets, and their customers, to play at the glacial speeds of the NYSE. It's Coke dictating Pepsi's business model.

Like "trade through," ITS technology that links the listed-exchange markets was developed decades ago and is, for all intents and purposes, prehistoric. Electronic markets have passed this technology on the superhighway countless laps ago.

As noted, our experience teaches that the NYSE uses the ITS Plan to suit its competitive purposes. It also hypocritically ignores and violates the ITS Plan when its terms do not meet its competitive purposes. Our databases are stuffed full of examples where NYSE wantonly violates the trade through rule by ignoring better prices at ArcaEx. In those instances, the

NYSE's own customers are left holding the bag when they get "worse execution" at the NYSE. As an all-electronic market, our prices can be accessed and executed in less time than it takes a flash bulb to fire. Despite that, the NYSE has traded through our better prices, and harmed their own customers, up to 7,500 times in a single week.

There is a glimmer of hope. The SEC itself initiated a pilot program over a year ago introducing "trade through" reform to the most actively traded equity product in the world, QQQ, and two other ETFs, SPY and DIA. The pilot has been a smashing success for investors and best execution. QQQ, for instance, maintains a 1-cent spread and deep, liquid markets throughout the trading day. ArcaEx now handles 25-30% of QQQ volume, while the Instinet ECN and the Island ECN handle 18% and 11%, respectively. The NYSE, in this brave new (reformed) world, executes a mere 5%. (No wonder the NYSE is fighting "trade through" reform.)

The SEC is now considering whether to expand on this success and broaden ITS reform to other securities. We respectfully comment that such a broadening would lower barriers, encourage competition, bring long-overdue reform to the listed marketplace, and ultimately benefit investors.

IV. Conclusion

The Inter-Market Trading System (ITS) – its rules, technology, and governance structure – is broken. Meaningful reform will occur at the NYSE and in the listed marketplace only when entry and competitive barriers are lowered to promote authentic competition. ITS is the manifestation of those barriers and, thus, must be reformed in order to cultivate market-wide reform. The experience of the Nasdaq scandal of the mid-1990s and the phoenix-like renewal of the OTC marketplace in its wake reconfirm that authentic reform is best achieved in a competitive and dynamic marketplace. We would argue the same holds true for the NYSE and listed-marketplace.